Economists love Uber’s surge pricing. But it is doomed, because customers hate it.

Why?

Surge pricing occurs when the supply and demand for Uber vehicles becomes unbalanced, for example, due to inclement weather, a public holiday such as New Years Eve or some other event (public transport failure, terrorist attack, …). Supply is low (who wants to drive in a snow storm?). However, demand is high (how do I get home when the rail network is down?). So, by raising the price (sometimes very substantially), Uber aims to encourage more drivers to pick up passengers and to ration the available supply to the customers who value the service the most.

The result is a New Year filled with negative Uber articles, both in Australia and overseas .

In the Harvard Business Review , Utpal Dholakia suggests that the near universal dislike of surge pricing is due to a lack of transparency and customers' lack of understanding about its benefits. He suggests education and transparency. But Uber is already embracing these strategies, trying to warn customers when surge pricing is likely and to make sure customers understand and agree to the surge price when requesting a car.

So Dholakia misses the key point.

It is not ignorance that leads to customer annoyance with surge pricing. Customers understand exactly what surge pricing does. *And that is why they do not like it*.

From the customers’ perspective, surge pricing does two things. First, it encourages more drivers and so makes it more likely that the customer can get home (or where ever else they are going) in less time (albeit at a higher - and possibly much higher - monetary price).

This is the economic ‘plus’ from surge pricing. Economists call this an allocative gain. It means that more mutually beneficial trade occurs because there are drivers who are only willing to drive for the higher price but there are also customers willing to pay that price. Setting a lower ‘normal’ price would just mean that the drivers stay at home and the customers don’t get home.

Second, however, surge pricing creates a transfer.

When I jump into the Uber car I don’t know if my driver only decided to work because of the surge pricing. He or she might have been out there anyway. And in that case, I just pay more even though the driver would have been there anyway. Of course, the driver also gets more. The money doesn’t disappear. It is a transfer. My loss through paying the higher surge price is the driver’s gain. So from an economic perspective, this transfer is neutral. But that doesn’t make the customer feel any happier.

So economists love surge pricing because it improves ‘allocative efficiency’. Customers tend to dislike it because it means all customers pay more, even if their driver would have been working regardless.

Surge pricing, and customers’ dislike of it, is simply one example of a common phenomena. When ever there is a shortage of a good or service and the market has a chance to work, the price rises and both rations existing supplies and encourages new supplies.

If a cyclone disrupts petrol supplies to Cairns, the price rises and those petrol retailers who just happened to have supplies in their storage tanks get a wind-fall gain. Customers pay more but this encourages petrol companies and private entrepreneurs to try and increase supplies.

Of course, if the same happened due to a hurricane in Florida, then “gas” prices could not rise. It would be illegal due to price gouging laws . So sellers with supplies don’t raise the (advertised) price. And it will take longer to get more supplies in (why hurry - there is no economic gain because the law has stopped the price from rising).

Some politicians in the US want to limit surge pricing claiming that it is ‘price gouging’.

However, a ban is a poor way to deal with surge pricing. It just hides the price rise or leads to non-monetary payments to ration the good or service. For example, if the monetary price can’t rise, and other forms of payment to sellers are avoided, then there will be long queues and a lot of wasted time. Customers pay in time rather than dollars. And paying an entrepreneurial student to wait in line for you rather than just paying more for the relevant product is a pure waste of resources.

So surge pricing is hated by consumers and is likely to lead to legal intervention over time. But banning surge pricing just leads to queues and inefficiency.

So what is the solution?

In many markets, ‘opportunistic’ price changes don’t occur because ‘regular’ sellers and buyers recognise the long-term nature of their relationship.

Customers often have long memories. So if a regular seller raises the price today because of a temporary shortage then customers may boycott that seller when normal times resume tomorrow. And sellers, knowing this, will try to respond to the shortage by more sophisticated pricing and information to customers. So the seller may make it clear that the price is kept lower to ‘regular’ customers even though it is higher to everyone else during the crisis. Or the seller may ration supplies to a ‘fair’ level for each buyer.

It is the short-term entrepreneurs, who only supply during the crisis, who charge more. But the higher price only applies to their product and is needed to give them the incentive to overcome the abnormally high cost of supply. So the market leads to allocative efficiency while it limits the transfer for sellers who ‘would have been there anyway’.

How does this relate to Uber?

Individual Uber drivers and customers are not in a long term supply relationship with each other. But Uber has a long term relationship with both its drivers and its customers. If Uber is to avoid being damaged by surge pricing, then it needs a more nuanced approach.

For example, instead of surge pricing everyone, the price rise could depend on the customers history. Regulars get a lower price than those who have just downloaded the App due to the crisis. Of course, to encourage drivers, they would need to receive a uniform higher price. So Uber would have to sit in the middle and manage payments. This will most likely lead to lower profits for Uber in the short run. However, it will be a long run investment in goodwill.

And if Uber does not come up with a better alternative to its hated surge pricing, one of its competitors will.

At the moment Uber’s surge pricing reflects naive economics. If Uber is going to thrive long term, particularly as new ride sharing Apps emerge and flourish, then it is going to need a more sophisticated economic approach to pricing.

Read more http://theconversation.com/why-ubers-surge-pricing-is-naive-economics-52948